No. 458

In the Supreme Court of the United States

OCTOBER TERM, 1960

R. A. BRYAN AND RUBY M. BRYAN, C. E. MCNARY AND ROWENA A. MCNARY, W. H. WEAVER AND EDITH H. WEAVER, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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In the Supreme Court of the United States

OCTOBER TERM, 1960

No. 453

R. A. BRYAN AND RUBY M. BRYAN, C. B. MCNAIRY AND ROWENA A. MCNAIRY, W. H. WEAVER AND EDITH H. WEAVER, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The Tax Court's opinion relating to taxpayers Bryan and McNairy (R. 4–49)[1] is reported at 32 T.C. 104, and its opinion relating to taxpayer Weaver (R. 50–88) is reported at 32 T.C. 411. The opinion of the court of appeals (Pet. 17a–26a) is reported at 281 F. 2d 238.

JURISDICTION

The judgment of the court of appeals was entered on July 13, 1960 (Pet. 16a). The petition for a writ

[1] "Taxpayers" refers to R. A. Bryan, C. B. McNairy, and W. H. Weaver. Their wives are parties only because joint returns were filed. Record references are to the appendix to the taxpayers' brief in the court of appeals.

of certiorari was filed on September 29, 1960. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

QUESTION PRESENTED

Whether the record supports the holdings of both courts below that two corporations in which the taxpayers were stockholders were collapsible corporations within Section 117(m) of the Internal Revenue Code of 1939, and that therefore gain realized by them upon the redemption of some of their stock in the corporations was taxable as ordinary income rather than as capital gain.

STATUTE AND REGULATIONS INVOLVED

The relevant provisions of Section 117(m) of the Internal Revenue Code of 1939 and Section 29.117–11 of Treasury Regulations 111 are set out in the Appendix, *infra*, pp. 11–27.

STATEMENT

The relevant facts as found by the Tax Court (R. 6–22, 51–66) and by the court of appeals (Pet. 18a–19a) may be summarized as follows:

Two construction companies, T. A. Loving & Company, controlled by taxpayers Bryan and McNairy and others, and W. H. Weaver Construction Company, controlled by taxpayer Weaver, formed a joint venture to bid upon certain Wherry Act housing projects to be constructed at the Fort Bragg Military Reservation, North Carolina. Through two corporations organized in 1950 for this purpose, Bragg Investment Company, Inc., and Bragg Development Company, Inc. (hereinafter referred to respectively as Investment

and Development), the taxpayers constructed four separate housing projects with F.H.A. insured loans aggregating $15,687,000. Investment and Development each issued 100 shares of preferred stock to the F.H.A. and 300 shares of Class A common stock for cash at $1 par value per share, with 60 shares issued to McNairy, 150 shares issued to Weaver, and 90 shares issued to Bryan.

The insured loans were obtained upon F.H.A. estimates of replacement costs of the projects. These estimates included items for architect fees in the amount of $834,356. After F.H.A. insured loans had been procured, and in line with the estimates in the loan applications, Class B common stock with an aggregate par value of $834,356 was issued to Seward H. Mott, an architect. In addition to the stock, Mott received $8,000 in cash. Previously Mott had agreed to do the work for $42,605.62. Upon receipt of the stock Mott promptly sold his stock, having a face value of $834,356, to the taxpayers for $44,605.62. The two corporations, Investment and Development, then redeemed a portion of the stock formerly held by Mott at par from the taxpayers for $618,368.

In their 1951 and 1953 income tax returns, the taxpayers reported these receipts on redemptions of the Class B stock of Investment and Development as long-term capital gains after deducting their payments to Mott as their claimed cost basis of the Class B common stock. The Commissioner determined that the full amount received upon redemption of the stock constituted ordinary income within the provisions of Section 22(a) and Section 117(m) of the Internal

Revenue Code of 1939. The Tax Court found and held (R. 22, 33–39, 66, 75) that Investment and Development were "collapsible corporations" as defined in Section 117(m), and that the gains were taxable as ordinary income. The court of appeals affirmed (Pet. 18a–20a).[2]

ARGUMENT

The decision below, affirming that of the Tax Court, is clearly correct. There is no conflict of decisions or other reason for further review of this case.

Section 117(m) of the Internal Revenue Code of 1939 (see the Appendix, *infra*, pp. 11–13) provides that "[g]ain from the sale or exchange * * * of stock of a collapsible corporation, to the extent that it would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months, shall [with certain exceptions] be considered as gain from the sale or exchange of property which is not a capital asset." The redemption distributions here involved—consisting of excess proceeds of F.H.A. insured mortgage loans over the costs of construction—are the very type which Section 117(m) was designed to cover. In a series of similar cases the lower courts have held the statute to be applicable. In fact, as the court below pointed out (Pet. 20a), the situation in the present case is "quite indistinguishable" from that of *Spangler* v. *Commissioner*, 278 F. 2d 665 (C.A. 4), certiorari denied, October 10, 1960. See also *Burge* v. *Commissioner*, 253 F. 2d 765 (C.A. 4); *Weil* v. *Commissioner*,

[2] The case was ordered remanded to the Tax Court for further proceedings as to a different issue (Pet. App. 18a).

252 F. 2d 805 (C.A. 2); *Glickman* v. *Commissioner*, 256 F. 2d 108 (C.A. 2); *Sorin* v. *Commissioner*, 271 F. 2d 741 (C.A. 2); *Sidney* v. *Commissioner*, 273 F. 2d 928 (C.A. 2); *Mintz* v. *Commissioner* (C.A. 2), decided November 17, 1960; *Abbott* v. *Commissioner*, 258 F. 2d 537 (C.A. 3); *August* v. *Commissioner*, 267 F. 2d 829 (C.A. 3); *Payne* v. *Commissioner*, 268 F. 2d 617 (C.A. 5). Each of the arguments which the taxpayers assert has been rejected in one or more of these cases.

1. Taxpayers' contention (Pet. 19-21) that the decision below conflicts with *Jacobson* v. *Commissioner*, 281 F. 2d 703 (C.A. 3), seeks to raise an issue not litigated in the court below. The decision in *Jacobson* turned on whether the "view" requirement of Section 117(m)(2) (Appendix, *infra*, p. 11) had been met. That subsection defines a "collapsible corporation" as "a corporation formed or availed of principally for the manufacture, construction, or production of property * * * with a view to — (i) the sale or exchange of stock by its shareholders * * * or a distribution to its shareholders, prior to the realization by the corporation * * * of a substantial part of the net income to be derived from such property, and (ii) the realization by such shareholders of gain attributable to such property." In the instant case, the taxpayers did not challenge the Tax Court's findings (R. 35-37) that the requisite "view" existed prior to completion of construction, and accordingly, the court below did not consider or pass upon the question. Having failed to raise the issue in the court below, taxpayers may not do so in the petition for certiorari.

Zellerbach v. *Helvering*, 293 U.S. 177, 182; *Lawn* v. *United States*, 355 U.S. 339, 362, fn. 16; *Duignan* v. *United States*, 274 U.S. 195, 200.

In any event, there is plainly no conflict between *Jacobson* and the present case. In dicta in two prior decisions of the Second and Fourth Circuits (*Glickman* v. *Commissioner*, *supra*, 256 F. 2d at 111, and *Burge* v. *Commissioner*, *supra*) the interpretation of the statutory "view" requirement contained in the Treasury Regulations (Section 29.117–11(b) of Regulations 111, Appendix, *infra*, pp. 14–16) was criticized as overly liberal in favor of taxpayers. These courts stated that, while the Regulations required that the view exist at some time "during the construction" or that the sale, exchange, or distribution be attributable "to circumstances which reasonably could be anticipated [at] the time of such * * * construction," the statute requires only that the view exist when the corporation is "availed of" for the purposes stated in Section 117(m). In *Jacobson*, the Third Circuit disagreed with these dicta,[3] but expressly upheld the interpretation of the "view" requirement in the Regulations, *i.e.*, that the requisite view may exist at any time during construction. See also *Weil* v. *Commissioner*, *supra*; *August* v. *Commissioner*, *supra*; *Sidney* v. *Commissioner*, *supra*; *Payne* v. *Commissioner*, *supra*. The Third Circuit reversed the Tax Court solely on the ground that there was "simply no substantial evidentiary basis" for its conclusion that

[3] The criticisms constituted dicta since the courts of appeals upheld the Tax Court's holdings in favor of the Commissioner on the basis of the Regulations, the same basis used by the Tax Court.

the taxpayers anticipated selling their stock prior to completion of construction. 281 F. 2d at 707. Since here, unlike *Jacobson*, the necessary "view" existed before or, at the least, during the construction, the asserted conflict with *Jacobson* manifestly reflects merely a difference in factual situations, rather than any disagreement as to applicable principles.[4]

2. Taxpayers contend (Pet. 22–28) that Section 117(m) is aimed solely at a distribution which results in complete liquidation of the corporation, or a sale of all of its stock to outsiders, or distribution of property of a corporation in kind, but not also at a cash distribution in redemption of part of the stock. This argument, however, runs directly counter to the language of that section and to its underlying purpose, as revealed by its legislative history and as expounded by the courts. It is simply a reiteration of essentially the same argument that has heretofore been rejected by every court which has passed upon the problem.

[4] In *Jacobson*, the court of appeals concluded that the sale was induced by the discovery, after completion of construction, of a crack in one of the buildings. In the present case, on the other hand, the evidence shows that the stock redemption was part of a single planned transaction initiated even prior to construction. Thus, the consideration which architect Mott was to receive ($52,605.62) was fixed before the incorporation of Investment and Development. Around the time construction commenced, in line with estimates in F.H.A. loan applications, Class B stock, having an aggregate par value of $34,356, was issued to the architect (in addition to $8,000 in cash), who promptly sold his stock to the taxpayers for $44,605.62. The corporations subsequently redeemed a portion of this stock from the taxpayers for $618,268 (see R. 11, 14, 19–20; Pet. 19a). Cf. *Payne* v. *Commissioner*, *supra*, 268 F. 2d at 620–621; *August* v. *Commissioner*, *supra*, 267 F. 2d at 834.

See, *e.g.*, *Spangler* v. *Commissioner*, *supra*, 278 F. 2d at 672; *Burge* v. *Commissioner*, *supra*, 253 F. 2d at 769; *Glickman* v. *Commissioner*, *supra*, 256 F. 2d at 110; *Mintz* v. *Commissioner*, *supra*. While cases involving complete liquidation of a corporation were prominent in the discussions preceding the enactment of Section 117(m), Congress realized that the abuse which it sought to remedy could take other forms. Accordingly, the "collapsible corporation" definition (Section 117(m)(2)(A)) was "drawn in broad general terms" (*Burge* v. *Commissioner*, *supra*, 253 F. 2d at 767), and it explicitly embraces "the sale or exchange of stock by its shareholders (whether in liquidation or otherwise) or a distribution to its shareholders." See also H. Rep. No. 2319, 81st Cong., 2d Sess., p. 97 (1950-2 Cum. Bull. 380, 449–450); S. Rep. No. 2375, 81st Cong., 2d Sess., p. 89 (1950-2 Cum. Bull. 483, 546–547). The "distributions" here involved—in redemption of portions of taxpayers' Class B stock—unquestionably fall within the purview of the statute.

3. Equally untenable is taxpayers' contention (Pet. 27–30) that the implementing Treasury Regulations (Section 29.117–11 of Regulations 111) transcend the provisions of Section 117(m) by treating as ordinary income gains from corporate distributions which previously had been taxable as capital gains under Section 115(d) of the 1939 Code (26 U.S.C. (1952 ed.) 115(d)). In fact, the Regulations are in complete harmony with the broad provisions of Section 117(m) and their legislative history, and have been sustained by every court which has passed upon their validity. At any rate, the decision here need not turn on the

interpretative Regulations; it is sustained by the statutory provisions themselves, to say nothing of the explanatory Committee Reports. Section 117(m)(1) expressly provides that it covers gains which "but for the provisions of this subsection," would be capital gains. Moreover, contrary to the taxpayers' assertions, the Committee Reports point out that Section 117(m) was intended to cover distributions which previously were taxable as capital gains under Section 115(d). See H. Rep. No. 2319, *supra*, p. 97 (1950–2 Cum. Bull. 380, 450); S. Rep. No. 2375, *supra*, p. 89 (1950–2 Cum. Bull. 483, 547). See also *Spangler* v. *Commissioner*, *supra*, 278 F. 2d at 672–673.

4. Nor is there any substance in taxpayers' suggestion (Pet. 28–29) that the Congress which enacted the corresponding provisions of the 1954 Code (Section 341), considered the Regulations promulgated under Section 117(m) of the 1939 Code to be invalid. On the contrary, it appears that Congress went to considerable length to indicate otherwise since the Committee Report on the 1954 Code explicitly disavows any inference that the previous Regulations were invalid. S. Rep. No. 1622, 83d Cong., 2d Sess., p. 260 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4898). See also Section 312(j) of the 1954 Code; S. Rep. No. 1622, *supra*, p. 47.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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DECEMBER 1960.

APPENDIX

Internal Revenue Code of 1939:

SEC. 117. CAPITAL GAINS AND LOSSES.

* * * * * * *

(m) [as added by Sec. 212(a) of the Revenue Act of 1950, c. 994, 64 Stat. 906] *Collapsible Corporations.*—

(1) *Treatment of gain to shareholders.*—Gain from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation, to the extent that it would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months, shall, except as provided in paragraph (3), be considered as gain from the sale or exchange of property which is not a capital asset.

(2) *Definitions.*—

(A) For the purposes of this subsection, the term "collapsible corporation" means a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to—

(i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property, and

(ii) the realization by such shareholders of gain attributable to such property.

(B) For the purposes of subparagraph (A), a corporation shall be deemed to have manufactured, constructed, or produced property, if—

(i) it engaged in the manufacture, construction, or production of such property to any extent,

(ii) it holds property having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, or produced the property, or

(iii) it holds property having a basis determined, in whole or in part, by reference to the cost of property manufactured, constructed, or produced by the corporation.

(3) *Limitations on application of subsection.*—In the case of gain realized by a shareholder upon his stock in a collapsible corporation—

(A) this subsection shall not apply unless, at any time after the commencement of the manufacture, construction, or production of the property, such shareholder (i) owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation, or (ii) owned stock which was considered as owned at such time by another shareholder who then owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation;

(B) this subsection shall not apply to the gain recognized during a taxable year unless more than 70 per centum of such gain is attributable to the property so manufactured, constructed, or produced; and

(C) this subsection shall not apply to gain realized after the expiration of three

years following the completion of such manufacture, construction, or production. For purposes of subparagraph (A), the ownership of stock shall be determined in accordance with the rules prescribed by paragraphs (1), (2), (3), (5), and (6) of section 503(a), except that, in addition to the persons prescribed by paragraph (2) of that section, the family of an individual shall include the spouses of that individual's brothers and sisters (whether by the whole or half blood) and the spouses of that individual's lineal descendants.

* * * * *

(26 U.S.C. (1952 ed.) 117)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.117-11 [as added by T.D. 5999, 1953-1 Cum. Bull. 187]. *Collapsible Corporations.*—(*a*) *In general.*—With respect to taxable years ending after December 31, 1949, but only with respect to gain realized after such date, and subject to the limitations contained in (*c*) hereof, the entire gain from (1) the actual sale or exchange of stock of a collapsible corporation, (2) amounts distributed in complete or partial liquidation of a collapsible corporation which are treated, under section 115(c), as payment in exchange for stock, and (3) a distribution made by a collapsible corporation which, under section 115(d), is treated, to the extent it exceeds the basis of the stock, in the same manner as a gain from the sale or exchange of property, shall be considered as gain from the sale or exchange of property which is not a capital asset.

(*b*) *Determination of collapsible corporation.*—With respect to taxable years ending after December 31, 1949, but only with respect to gain realized after such date, a collapsible corporation is defined by section 117(m)(2)

(A) to be a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to (1) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property, and (2) the realization by such shareholders of gain attributable to such property. With respect to taxable years ending after August 31, 1951, but only with respect to gain realized after such date, the definition of a collapsible corporation under section 117(m)(2)(A) is expanded to include a corporation formed or availed of principally for the purchase of property which (in the hands of the corporation) is property described in section 117(a)(1)(A), or for the holding of stock in a corporation so formed or availed of, with a view to (1) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation purchasing the property of a substantial part of the net income to be derived from such property, and (2) the realization by such shareholders of gain attributable to such property.

See (*d*) of this section for a description of the facts which will ordinarily be considered sufficient to establish whether or not a corporation is a collapsible corporation under the rules of the section. See (*e*) of this section for example of the application of section 117(m).

Under section 117(m)(2)(A), the corporation must be formed or availed of with a view to the action therein described, that is, the sale or exchange of its stock by its shareholders, or

a distribution to them, prior to the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the net income to be derived from such property, and the realization by the shareholders of gain attributable to such property. This requirement is satisfied in any case in which such action was contemplated by those persons in a position to determine the policies of the corporation, whether by reason of their owning a majority of the voting stock of the corporation or otherwise. The requirement is satisfied whether such action was contemplated unconditionally, conditionally, or as a recognized possibility. If the corporation was so formed or availed of, it is immaterial that a particular shareholder was not a shareholder at the time of the manufacture, construction, production, or purchase of the property; or if a shareholder at such time, did not share in such view, and any gain of such shareholder on his stock in the corporation shall be treated in the same manner as gain of a shareholder who did share in such view. See, however, the limitation contained in (*e*)(2) hereof. The existence of a bona fide business reason for doing business in the corporate form does not, by itself, negate the fact that the corporation may also have been formed or availed of with a view to the action described in section 117(m)(2)(A).

A corporation is formed or availed of with a view of the action described in section 117(m)(2)(A) if the requisite view existed at any time during the manufacture, production, construction, or purchase referred to in that section. Thus, if the sale, exchange, or distribution is attributable solely to circumstances which arose after the manufacture, construction, production, or purchase (other than circumstances which reasonably could be anticipated at the time of such manufacture, construction, production, or purchase), the corporation shall, in the absence

of compelling facts to the contrary, be considered not to have been so formed or availed of. However, if the sale, exchange, or distribution is attributable to circumstances present at the time of the manufacture, construction, production, or purchase, the corporation shall, in the absence of compelling facts to the contrary, be considered to have been so formed or availed of.

The property referred to in section 117(m)(2)(A) is that property or the aggregate of those properties with respect to which the requisite view existed. In order to ascertain the property or properties as to which the requisite view existed, reference shall be made to each property as to which, at the time of the sale, exchange, or distribution referred to in section 117(m)(2)(A), there has not been a realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the net income to be derived from such property. However, where any such property is a unit of an integrated project involving several properties similar in kind, the determination whether the requisite view existed shall be made only if a substantial part of the net income to be derived from the project has not been realized at the time of the sale, exchange, or distribution, and in such case the determination shall be made by reference to the aggregate of the properties constituting the single project.

A corporation shall be deemed to have manufactured, constructed, produced, or purchased property if it (1) engaged in the manufacture, construction, or production of property to any extent, or (2) holds property having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, produced, or purchased the property, or (3) holds property having a basis determined, in whole or in

part, by reference to the cost of property manufactured, constructed, produced, or purchased by the corporation. Thus, under (1), for example, a corporation need not have originated nor have completed the manufacture, construction, or production of the property. Under (2), for example, if an individual were to transfer property constructed by him to a corporation in exchange for all of the capital stock of such corporation, and such transfer qualifies under section 112(b)(5), then the corporation would be deemed to have constructed the property, since the basis of the property in the hands of the corporation would, under section 113(a)(8), be determined by reference to the basis of the property in the hands of the individual. Under (3), for example, if a corporation were to exchange property constructed by it for property of like kind constructed by another person, and such exchange qualifies under section 112(b)(1), then the corporation would be deemed to have constructed the property received by it in the exchange since the basis of the property received by it in the exchange would, under section 113(a)(6), be determined by reference to the basis of the property constructed by the corporation.

In determining whether a corporation is a collapsible corporation by reason of the purchase of property, it is immaterial whether the property is purchased from the shareholders of the corporation or from persons other than such shareholders. The property, however, must be property which, in the hands of the corporation, is property of a kind described in section 117(a)(1)(A). Section 117(a)(1)(A) describes the following property: stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the

ordinary course of its trade or business. The determination whether property is of a kind described in section 117(a)(1)(A) shall be made without regard to the fact that the corporation is formed or availed of with a view to the action described in section 117(m)(2)(A).

Section 117(m) is applicable whether the shareholder is an individual, a trust, an estate, a partnership, a company, or a corporation.

(c) *Limitations on application of section.*—(1) *General.*—This section shall apply only to the extent that the recognized gain of a shareholder upon his stock in a collapsible corporation would be considered, but for the provisions of this section, as gain from the sale or exchange of a capital asset held for more than 6 months. Thus, if a taxpayer sells at a gain stock of a collapsible corporation which he has held for 6 months or less, this section would not, in any event, apply to such gain. Also, if it is determined, under provisions of law other than section 117(m), that a sale or exchange at a gain of stock of a collapsible corporation which has been held for more than 6 months results in ordinary income rather than long-term capital gain, then this section (including the limitations contained herein) has no application whatsoever to such gain.

(2) *Stock ownership rules.*—This section shall apply in the case of gain realized by a shareholder upon his stock in a collapsible corporation only if the shareholder, at any time after the actual commencement of the manufacture, construction, or production of the property, or at the time of the purchase of the property described in section 117(a)(1)(A) or at any time thereafter, (i) owned, or was considered as owning, more than 10 percent in value of the outstanding stock of the corporation, or (ii) owned stock which was considered as owned at such time by another shareholder who then owned, or was considered as owning,

more than 10 percent in value of the outstanding stock of the corporation.

The ownership of stock shall be determined in accordance with the rules prescribed by section 503(a) (1), (2), (3), (5), and (6), except that, in addition to the persons prescribed by section 503(a)(2), the family of an individual shall include the spouses of that individual's brothers and sisters, whether such brothers and sisters are by the whole or the half blood, and the spouses of that individual's lineal descendants.

For the purpose of this limitation, treasury stock shall not be considered as outstanding stock.

It is possible, under this limitation, that a shareholder in a collapsible corporation may have gain upon his stock in that corporation treated differently from the gain of another shareholder in the same collapsible corporation.

(3) *Seventy-percent rule.*—This section shall apply to the gain recognized during a taxable year upon the stock in a collapsible corporation only if more than 70 percent of such gain is attributable to the property referred to in section 117(m)(2)(A). If more than 70 percent of such gain is so attributable, then all of such gain is subject to this section, and, if 70 percent or less of such gain is so attributable, then none of such gain is subject to this section.

For the purpose of this limitation, the gain attributable to the property referred to in section 117(m)(2)(A) is the excess of the recognized gain of the shareholder during the taxable year upon his stock in the collapsible corporation over the recognized gain which the shareholder would have if the property had not been manufactured, constructed, produced, or purchased. In the case of gain on a distribution in partial liquidation or a distribution described in section 115(d), the gain attributable to the property shall not be less than an amount which

bears the same ratio to the gain on such distribution as the gain which would be attributable to the property if there had been a complete liquidation at the time of such distribution bears to the total gain which would have resulted from such complete liquidation.

Gain may be attributable to the property referred to in section 117(m)(2)(A) even though such gain is represented by an appreciation in the value of property other than that manufactured, constructed, produced, or purchased. Where, for example, a corporation owns a tract of land and the development of one-half of the tract increases the value of the other half, the gain attributable to the developed half of the tract includes the increase in the value of the other half.

(4) *Three-year rule.*—This section shall not apply to that portion of the gain of a shareholder that is realized more than 3 years after the actual completion of the manufacture, construction, production, or purchase of the property to which such portion is attributable.

(*d*) *Application of section.*—(1) Whether or not a corporation is a collapsible corporation shall be determined under the rules of (*b*) of this section on the basis of all the facts and circumstances in each particular case. The following paragraphs set forth those facts which will ordinarily be considered sufficient to establish that a corporation is or is not a collapsible corporation. The facts set forth in the following paragraphs are not exclusive of other facts which may be controlling in any particular case. For example, if the facts in paragraph (2), but not the facts in paragraph (3), are present, the corporation may nevertheless not be a collapsible corporation if there are other facts which clearly establish that the rules of (*b*) of this section are not satisfied. Similarly, if the facts in paragraph (3) are present, the corporation may nevertheless be

a collapsible corporation if there are other facts which clearly establish that the corporation was formed or availed of in the manner described in (*b*) of this section, or if the facts in paragraph (3) are not significant by reason of other facts, such as the fact that the corporation is subject to the control of persons other than those who were in control immediately prior to the manufacture, construction, production, or purchase of the property.

See (*c*) of this section for provisions which make section 117(m) inapplicable to certain shareholders of collapsible corporations.

(2) The following facts will ordinarily be considered sufficient (except as otherwise provided in paragraph (1), above, and paragraph (3), below) to establish that a corporation is a collapsible corporation:

(i) A shareholder of the corporation sells or exchanges his stock, or receives a liquidating distribution, or a distribution described in section 115(d),

(ii) Upon such sale, exchange, or distribution, such shareholder realizes gain attributable to the property described below, and

(iii) At the time of the manufacture, construction, production, or purchase of the property described below, such activity was substantial in relation to the other activities of the corporation which manufactured, constructed, produced, or purchased such property.

The property referred to above is that property or the aggregate of those properties which meet the following two requirements:

(iv) The property is manufactured, constructed, or produced by the corporation or by another corporation stock of which is held by the corporation, or is property purchased by the corporation or by such other corporation which (in the hands of the cor-

poration holding such property) is property described in section 117(a)(1)(A) (relating to stock in trade, inventories, and property held primarily for sale to customers), and

(v) At the time of the sale, exchange, or distribution described in (i) above, the corporation which manufactured, constructed, produced, or purchased such property has not realized a substantial part of the net income to be derived from such property.

In the case of property which is a unit of an integrated project involving several properties similar in kind, the rules of this paragraph shall be applied to the aggregate of the properties constituting the single project rather than separately to such unit. Under the rules of this paragraph, a corporation shall be considered a collapsible corporation by reason of holding stock in other corporations which manufactured, constructed, produced, or purchased the property only if the activity of the corporation in holding stock in such other corporations is substantial in relation to the other activities of the corporation.

(3) The absence of any of the facts set forth in paragraph (2) or the presence of the following facts will ordinarily be considered sufficient (except as otherwise provided in paragraph (1), above) to establish that a corporation is not a collapsible corporation:

(i) In the case of a corporation subject to the rules of paragraph (2) only by reason of the manufacture, construction, production, or purchase (either by the corporation or by another corporation the stock of which is held by the corporation) of property which is property described in section 117(a)(1)(A), the amount (both in quantity and value) of such property is not in excess of the amount which is normal—

(A) For the purpose of the business activities of the corporation which manufactured, constructed, produced, or purchased the property if such corporation has a substantial prior business history involving the use of such property and continues in business, or

(B) For the purpose of an orderly liquidation of the business if the corporation which manufactured, constructed, produced, or purchased such property has a substantial prior business history involving the use of such property and is in the process of liquidation.

(iii) In the case of a corporation subject to the rules of paragraph (2) with respect to the manufacture, construction, or production (either by the corporation or by another corporation the stock of which is held by the corporation) of property, the amount of the unrealized net income from such property is not substantial in relation to the amount of the net income realized (after the completion of a material part of such manufacture, construction, or production, and prior to the sale, exchange, or distribution referred to in paragraph (2)(i)) from such property and from other property manufactured, constructed, or produced by the corporation.

(c) *Examples.* The following examples will illustrate the application of this section:

Example (1). On January 2, 1951, A formed the W Corporation and contributed $50,000 cash in exchange for all of the stock thereof. The W Corporation borrowed $900,000 from a bank, the loan being insured by the Federal Housing Authority, and used $850,000 of such sum in the construction of an apartment house on land which it purchased for $50,000. The apartment house was completed on December 31, 1951. On December 31, 1951, the corpora-

tion, having determined that the fair market value of the apartment house, separate and apart from the land, was $900,000, made a distribution (permitted under the applicable state law) to A of $100,000. At this time, the fair market value of the land was $50,000. As of December 31, 1951, the corporation has not realized any earnings and profits. In 1952, the corporation began the operation of the apartment house and received rentals therefrom. The corporation has since continued to own and operate the building. The corporation reported on the basis of the calendar year and cash receipts and disbursements.

Since A received a distribution and realized a gain attributable to the building constructed by the corporation, since, at the time of such distribution, the corporation has not realized a substantial part of the net income to be derived from such building, and since the construction of the building was a substantial activity of the corporation, the W Corporation is considered a collapsible corporation under (*d*)(2) of this section. The provisions of section 117(m)(3) do not prohibit the application of section 117(m)(1) to A. Therefore, the distribution, if and to the extent that it may be considered long-term capital gain rather than ordinary income without regard to section 117(m), will be considered ordinary income under section 117(m)(1).

In the event of the existence of additional facts and circumstances in the above case, the corporation, notwithstanding the above facts, might not be considered a collapsible corporation. See (*b*) and (*d*)(1) of this section.

Example 2. On January 2, 1950, B formed the X Corporation and became the sole shareholder thereof. This corporation completed the construction of an office building in 1950. Immediately after the completion of the building, the corporation sold this building at a gain of

$50,000, included this entire gain in its return for 1950, and distributed this entire gain (less taxes) to B. The corporation completed the construction of a second office building in June 1951. In August 1951, B sold the entire stock of the X Corporation at a gain of $12,000, which gain is attributable to the second building. In view of the fact that B sold stock of the X corporation and realized a gain attributable to the second office building, that, at the time of such sale, the corporation had not realized a substantial part of the net income to be derived from such building, and that the construction of such building during the time of such construction was a substantial activity of the corporation, the X Corporation is considered a collapsible corporation under (*d*)(2) of this section. Since the provisions of section 117(m)(3) do not prohibit the application of section 117(m)(1) to B, the gain of $12,000 to B is, accordingly, considered ordinary income.

Example (3). The facts in this example are the same as in example (2), except that the following facts are shown: B was the president of the X Corporation and active in the conduct of its business. The second building was constructed as the first step in a project of the X Corporation for the development for rental purposes of a large suburban center involving the construction of several buildings by the corporation. The sale of the stock by B was caused by his retiring from all business activity as a result of illness arising after the second building was constructed. Under these additional facts, the corporation is not considered a collapsible corporation. See (*b*) and (*d*)(1) of this section.

Example (4). On January 2, 1947, C formed the Y Corporation and became the sole shareholder thereof. The Y Corporation has been engaged solely in the business of producing motion pictures and licensing their exhibition.

On January 2, 1952, C sold all of the stock of the Y Corporation at a gain. The Y Corporation has produced one motion picture each year since its organization and prior to January 2, 1952, it has realized a substantial part of the net income to be derived from each of its motion pictures except the last one made in 1951. This last motion picture was completed September 1, 1951. As of January 2, 1952, no license had been made for its exhibition. The fair market value on January 2, 1952, of this last motion picture exceeds the cost of its production by $50,000. A material part of the production of this last picture was completed on January 1, 1951, and between that date and January 2, 1952, the corporation had realized net income of $500,000 from other motion pictures produced by it. The corporation has consistently distributed to its shareholder its net income when received (after adjustment for taxes).

Although the corporation is within (*d*)(2) of this section with respect to the production of property, the amount of the unrealized net income from such property ($50,000) is not substantial in relation to the amount of the net income realized, after the completion of a material part of the production of such property and prior to sale of the stock, from such property and other property produced by the corporation ($500,000). Accordingly, the Y Corporation is within (*d*)(3)(ii) of this section, and is not considered a collapsible corporation.

Example (5). The facts are the same as in example (*4*) except that C sold all of his stock to D on February 1, 1951. On January 2, 1952, D sold all of the Y Corporation stock at a gain, the gain being attributable to the picture completed September 1, 1951, and not released by the corporation for exhibition. In view of the change of control of the corporation, the provisions of (*d*)(3)(ii) are not significant at the time of the sale by D, and the Y Corporation

would be considered a collapsible corporation on January 2, 1952. See (*b*) and (*d*)(1) of this section.

Section 39.117–11 of Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939, effective for the taxable years beginning with 1952, is similar to Section 29.117–11 of Treasury Regulations 111.

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